No. 88-1400

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1988

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FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA; LEONARD WILSON, Individually and as District Manager, Chicago Office of the Franchise Tax Board of the State of California; and B.M. RARANG, Individually and as Auditor, Chicago Office of the Franchise Tax Board of the State of California,
*Petitioners,*

v.

ALCAN ALUMINIUM LIMITED AND IMPERIAL CHEMICAL INDUSTRIES, PLC,
*Respondents.*

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**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

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**BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE SUPPORTING RESPONDENTS**

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F. EUGENE WIRWAHN
511 Woodland Court, N.W.
Vienna, Virginia 22180
(703) 938-5634
*Counsel for the Government of the United Kingdom as Amicus Curiae*

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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### INTEREST OF AMICUS CURIAE

The United Kingdom and the United States are allies and major trading partners. The United Kingdom is the largest investor in the United States and the second largest recipient of U.S. direct foreign investment. A major portion of British investment in the United States is by United Kingdom corporations. The issue before this

Court, whether foreign parent corporations have standing to challenge Petitioners' application of worldwide combined reporting ("WWCR") in Federal court, is of general and specific concern to the Government of the United Kingdom ("the United Kingdom"). The Income Tax Convention with the United Kingdom of Great Britain, and Northern Ireland ("the Treaty") prohibits the use of WWCR by either country. Nevertheless, Petitioners have applied WWCR, thereby disrupting the trading and investment relations between the two countries.

Respondent Imperial Chemical Industries, PLC ("ICI") is a United Kingdom corporation. Like numerous other United Kingdom corporate citizens, ICI does not have a permanent establishment and does not conduct business in the United States. It has numerous subsidiary corporations which conduct business throughout the world, including United States subsidiaries with extensive business operations in the United States. When Petitioners, through their application of WWCR, include the income and apportionment factors of a United Kingdom parent corporation, like ICI, and all of its overseas subsidiaries in the tax base of the American subsidiary, the United Kingdom corporation is directly and adversely burdened. If Petitioners prevail here, there is no forum in which United Kingdom corporations can question Petitioners' application of WWCR and seek relief from the burdens it imposes. The United Kingdom hereby submits this brief *amicus curiae* in support of Respondents.[1]

## SUMMARY OF ARGUMENT

There is only one internationally accepted method of corporate tax allocation among countries and that is the arm's length/separate accounting method ("AL/SA"). AL/SA is used by the United Kingdom and the United States and every other major trading nation. Its use is required by every double tax treaty to which the United States is a party and is codified in the Internal Revenue Code. Under AL/SA, income of a foreign corporation is not subject to tax solely by virtue of its being a shareholder of a subsidiary in the taxing jurisdiction.

[1] Petitioners and Respondents have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.



Petitioners' use of WWCR contradicts international tax policy. The extraterritorial effects of Petitioners' use of WWCR has offended the trading partners of the United States, damaged business relations between the United Kingdom and the United States and finally forced the United Kingdom to enact retaliatory legislation.

United Kingdom and other foreign parent corporations are directly and adversely burdened by Petitioners' application of WWCR. When the Petitioners combine the entire worldwide corporate groups of which Respondents are the foreign parent corporations, solely on the basis that Respondents are shareholders in subsidiaries doing business in California, income which has already been subject to tax in the United Kingdom or other countries of domicile is being doubly taxed by California.

By its very nature, the types of financial information which Petitioners demand relating to Respondents and their foreign subsidiaries can only be satisfied, if at all, by Respondents, not by their American subsidiaries. WWCR's apportionment formula with its extraterritorial reach forces foreign parent corporations like Respondents to have to consider the impacts upon the taxation of their domestic subsidiaries in California when they make decisions in the normal course of business regarding capital investments in other countries and foreign subsidiaries.

The deleterious effects which directly burden Respondents and interfere with their foreign commerce provide standing for Respondents in Federal courts and meet the tests established by this Court to judge the unconstitutionality of state taxes.

## ARGUMENT

**I. The interference in the foreign commerce of United Kingdom corporations and the damaging effect on the business relations between the United Kingdom and the United States resulting from Petitioners' use of worldwide combined reporting is of grave concern to the United Kingdom.**

WWCR is not used by the United Kingdom, the United States, or any other country. WWCR is used by only four of the states in the United States that tax corporate income and one of the four states (Montana) does not apply it to foreign based multi-corporate groups. AL/SA is the internationally accepted method of corporate tax assessment. This Court has recognized that WWCR is a "serious divergence" from the internationally accepted AL/SA.[2]

No country under AL/SA subjects the income of foreign corporations or its foreign subsidiaries to tax merely because the foreign corporations are shareholders or the parents of a domestic subsidiary. Accordingly, the United States' Internal Revenue Code does not subject the income of a foreign parent corporation and its foreign subsidiaries to tax merely because the foreign parent corporation is a shareholder of an American subsidiary. Also in no case is income apportioned on an arbitrary basis under AL/SA. Subjecting foreign corporations to tax solely because they are shareholders of a California subsidiary and apportioning income on an arbitrary basis is exactly what WWCR does.

Under AL&SA, the income of each corporate member of a corporate group is computed by separate accounting on the basis that each member of the group must deal with each other as if they were wholly separate entities owned by unrelated interests. Both the Mexican Draft

[2] *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159 (1983).



and the London Draft of the Model Bilateral Tax Convention on Income and Property of the League of Nations adopted the AL/SA concept in Article IV, as supplemented by Article VI of their Protocols. The Commentary of the Fiscal Committee of the League of Nations states that the method of determining or allocating the profits attributable to a permanent establishment of a foreign enterprise in a country "is known as the method of separate accounting."[3] The intent was expressed:

> that each establishment or branch is taxed as if it constituted a distinct independent enterprise and the profits of the establishment are assessed independently of the results of the business done elsewhere.[4]

In July 1979, the Council of the Organization for Economic Cooperation and Development ("OECD"), of which the United States is a member, reaffirmed the recommendation for the use of AL/SA rather than WWCR.[5] The use of AL/SA, not WWCR, is required by the Treaty; all of the double taxation treaties to which the United States' other major trading partners, such as Canada and Australia, Belgium, Denmark, France, Federal Republic of Germany, Greece, Japan, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and Switzerland are signatories; and the model treaties of the United States, OECD, the United Nations.[6]

[3] The Commentary of the Fiscal Committee of the League of Nations 18 (Nov. 1946).

[4] *Id.*

[5] Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs (1979).

[6] Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention for Income and on Capital, arts. 5(7), 7(2), 9(1) (1977); United Nations Model Double Taxation Convention Between Developed and Developing Countries, arts. 5(8), 7(2), 9(1), U.N. Doc. ST/WSA/102 (1980); U.S. Treasury Depart-

The requirement for AL/SA has been contained in every tax treaty to which the United States has been a party since the first such treaty signed with France on April 27, 1932.[7] That requirement was in turn taken from the predecessor to Internal Revenue Code § 482, first adopted by Congress in the Revenue Act of 1928. The fundamental principle contained in § 482 is that income is to be determined on a separate accounting basis governed by the requirement that all intercompany dealings between parties must meet the arm's length standard.[8]

WWCR rejects the international corporate taxation principles of AL/SA. Petitioners' using WWCR treat separate corporations—foreign and domestic—that are part of a multi-corporate group as one, and subject all the worldwide income of the international corporate group to tax as one "unitary" corporation. Petitioners apportion the group's combined income between California and the rest of the world on the basis of an arbitrary formula composed of the ratio of payroll, sales, and property of the combined corporate group in California compared

ment's Model Income Tax Treaty of June 16, 1981, arts. 5(7), 7(2), 9(1), I Tax Treaties (CCH) 153.

All of the U.S. treaties for the prevention of double taxation contain an absolute prohibition on U.S. taxation of the profits of a foreign corporation which does not have a permanent establishment in the U.S. The following language from Article 7 of the OECD model convention exemplifies this prohibition:

> The profits of an enterprise of a Contracting State shall be taxable only in that state unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

Article 9 of the OECD model convention, the counterpart to Internal Revenue Code § 482, provides that dealings between related parties may be placed upon an arm's length, independent enterprise basis.

[7] Article IV, TS 885, 49 Stat. 3145.

[8] 26 U.S.C. § 482.



to the world. Moreover, Petitioners combine the income without regard to whether such income is taxable under the Internal Revenue Code or applicable treaty, and without regard to the fact that income has been attributed to and taxed to foreign jurisdictions, under long standing and well recognized procedures established in international law.

The United Kingdom has repeatedly objected to the extra-territorial results of WWCR and was forced to enact retaliatory legislation. The instruments of ratification for the Treaty, exchanged in Washington, D.C. on March 25, 1980, included Diplomatic Note No. 51 emphasizing:

> Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied to the international field is entirely unsatisfactory.
>
> It is the view of Her Majesty's Government that the unitary basis, which is not a practical alternative to the 'arm's length' basis, could undo the important and patient international work that has been achieved in regulating international tax practices. . . .[9]

On July 12, 1983, the Chancellor of the Exchequer wrote to the Secretary of the Treasury of the United States, Donald T. Regan, that the United Kingdom was: "keen for the matter to be resolved . . . before harm is done between our two countries." In September 1983, The Prime Minister, Margaret Thatcher, warned the Federal Government: "We might be under very severe pressure to take retaliatory action." [10] Frustration with the continued use of WWCR led 296 Members of the

[9] Note No. 51 Submitted by the United Kingdom to the Department of State (March 25, 1980).

[10] House of Commons Official Report, *Parliamentary Debates*, (Hansard) 1022 (9 July 1985) (statment of Michael Grylls).

House of Commons to support in April 1984 early day motion number 202 calling for retaliatory measures to be included in the United Kingdom's 1984 Finance Bill.[11] The United Kingdom felt it premature to retaliate at that time.[12]

With the support of over 250 Members, a retaliatory amendment to the 1985 Finance Bill was introduced in the House of Commons and debated and accepted on July 9, 1985.[13] During the debate, John Moore, Financial Secretary to the Treasury, on behalf of the United Kingdom endorsed the statements that the entire House of Commons:

> . . . felt frustration that a solution to the problem had so long been delayed;

and acknowledged:

> . . . that the time had come for Parliament to take legislative action to register the United Kingdom's determination that a solution is achieved in the United States.[14]

The amendment [enacted as Section 54 of and Schedule 13 to the 1985 Finance Act] gave the United Kingdom power to retaliate for the use of WWCR by withdrawing from American corporations incorporated in California or having their principal place of business there, the right to claim shareholders' tax credit in respect of dividends paid to them by their United Kingdom subsidiaries.[15]

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[11] Order Papers—House of Commons.

[12] House of Commons Official Report, *Parliamentary Debates*, (Hansard) 1021 (9 July 1985) (statement of Michael Grylls).

[13] House of Commons Official Report, *Parliamentary Debates*, (Hansard) 1016-1037 (9 July 1985).

[14] House of Commons Official Report, *Parliamentary Debates*, (Hansard) 1034 (9 July 1985) (statement of John Moore).

[15] House of Commons Official Report, *Parliamentary Debates*, (Hansard) 1014-1018 (9 July 1985).



**II. When worldwide combined reporting is applied to foreign corporations with American subsidiaries, the foreign corporation is directly, necessarily and adversely effected.**

Petitioners depict the United Kingdom parent corporation, ICI, as a mere "shareholder" that is not directly injured by the application of WWCR.[16] They contend that the resulting tax is not being levied on ICI or its overseas subsidiaries, but only on the American subsidiary doing business in California. From this erroneous premise they conclude that only the in-state subsidiary corporation is affected by the tax and has the standing to challenge its imposition.

The fault in this line of reasoning is obvious. The basis on which the Petitioners compute the tax is the income of the unitized business group, including the out-of-state members. Petitioners' portrayal cannot disguise the fact that to demand extensive information about, and to assess the collection of tax on, the income of foreign corporate members of the multi-corporate group including the Respondents substantially impacts administratively and economically on the foreign corporate parents.

The arithmetic results of applying WWCR also belie Petitioners' argument that WWCR does not tax foreign source income of the foreign parents and foreign subsidiaries of the subsidiary in California. Petitioners in effect require a consolidated income tax return and subject to tax the income earned by foreign members of the international corporate group without giving any relief for foreign tax. In other words, Petitioners have extended the state of California's taxing jurisdiction to bring into its tax net income over which foreign nations will have exercised their priority taxing rights under the normal AL/SA arrangements and treaties. As the United Kingdom has previously made clear:

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[16] Brief for the Petitioners, p. 16.

The element of double counting this involves can and does lead to multinational groups being taxed on more than 100 per cent of their income.[17]

Petitioners use the same portrayal to describe the extensive detailed demands they make for information on the operations of the foreign based worldwide corporate group as being "only addressed" to the American subsidiary and allege that the foreign parent corporation will suffer no direct harm if it does not reply.[18] There is no need to repeat the explanation contained in Respondents' briefs of the depth and breadth of those information demands. However, it is obvious that information of the detail and extent regarding the whole worldwide corporate group could not reasonably be expected to be kept by any subsidiary, especially when under the internationaly accepted AL/SA, foreign corporations are not subject to tax in the United States on their foreign source income.

If the foreign parent is unable or chooses not to comply with Petitioners' demands for worldwide information it is directly penalized because arbitrary assumptions will be made based on annual reports, for example, which will increase the tax that would otherwise be payable by the American subsidiary under WWCR. The increment attributable to the foreign parent corporation's refusal to supply information is in reality a tax on it to force its compliance. Conversely, if the foreign parent corporation can and does comply, the costs to it may exceed the California tax asserted by Petitioners, as explained in Respondents' briefs.

Federal law requires that domestic subsidiaries of foreign parents provide information only with respect to

[17] Paper Submitted by the Government of the United Kingdom Before the United States Treasury Working Group on Worldwide Unitary Taxation, pp. 11-12.

[18] Brief for the Petitioners, p. 38.



those foreign affiliates that had a "transaction with" the reporting domestic corporation. The information that must be furnished in those cases is limited to readily available information regarding the foreign affiliate and the transactions conducted with it.[19] Thus Petitioners here are seeking worldwide financial data that goes far beyond the limited transactional data that must be furnished to comply with Federal law. The United Kingdom believes an intolerable burden is imposed on foreign commerce to obtain and deliver to Petitioners such detailed financial data, stated in United States dollar terms, for scores of worldwide subsidiaries that do no business in California, or elsewhere in the United States, and have no business contacts with the U.S. subsidiary that does do business there.

Petitioners portray the compliance burden they impose on foreign parent corporations to deliver the detailed information on the worldwide corporate group, which only they as parent corporations, if anyone, can prepare at great cost, as information which "they deem essential to a fairer calculation of taxes assessed against their subsidiaries." [20] Petitioners' brief reveals the contradiction inherent in that characterization. For purposes of reporting under WWCR, the entire worldwide corporate group, of which Respondents in this instance are the parent corporations, is the "taxpayer." [21] For purposes of tax collection and ability to contest such taxes in California state courts, only the California subsidiary is the "taxpayer." [22] Petitioners describe the latter definition of "taxpayer" as the "California taxpayer in the tradi-

[19] Internal Revenue Code of 1986, as amended: 26 U.S.C. § 6038A.

[20] Brief for the Petitioners, p. 39.

[21] Cal. Rev. & Tax. Code § 25102.

[22] Cal. Rev. & Tax. Code § 23151.

tional sense of the party actually subject to state taxation." [23]

Under the internationally accepted traditional definition of taxpayer, taxing authorities would not require worldwide information about the foreign parent or foreign subsidiaries of a corporation in their jurisdiction simply because the foreign parent corporation owned stock in a domestic subsidiary. Similarly, under the internationally accepted traditional definition of taxpayer, that subsidiary would not have its tax computed based upon the payroll, property and sales of the entire worldwide corporate group. Obviously, it is the foreign parent corporation which directly bears the burden of Petitioners' application of WWCR.

The Seventh Circuit Court of Appeals recognized that the choices about the manner in which international trade is conducted are "primarily the parents' choices" and that the injury to the foreign parents caused by the distortion of these choices which result from Petitioners' use of WWCR also can not be dismissed as "indirect and derivative." [24] Under the internationally accepted AL/SA, a foreign parent corporation does not have to consider the impact upon its own domestic tax base or the tax base of its nonconcerned subsidiaries when making decisions with respect to changing capital investments in other countries. However, when a foreign parent corporation makes changes in capital investment overseas, the worldwide application of the WWCR apportionment formula forces it to take into account the impact upon the California tax base. The extraterritorial effects of Petitioners' use of WWCR hampers rather than promotes economic efficiency, distorting investment patterns and inhibiting trade throughout the world.

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[23] Brief of Petitioners, p. 40.

[24] *Alcan Aluminium Ltd. and Imperial Chemical Industries PLC v. Franchise Tax Board,* 860 F.2d 688 at 698 (7th Cir. 1988).



**III. The Tax Injunction Act does not restrict the right of foreign corporations to contest in Federal court Petitioners' use of worldwide combined reporting.**

Petitioners concede that California's administrative and judicial remedies are available only to the subsidiaries and not their foreign parent corporations.[25] They would compound the direct, necessary and adverse economic and administrative impacts of WWCR upon foreign corporations by depriving them of access to Federal courts under the Tax Injunction Act. 28. U.S.C. § 1341. The Seventh Circuit Court of Appeals held that the Tax Injunction Act is inapplicable here, as a plain, speedy and effective remedy is not available to Respondents in California.[26]

As discussed above, the United States and the vast majority of states in the United States do not use WWCR. In fact, how Petitioners apply WWCR has little relevance to most states.[27] Therefore, the contention that the upholding of the Seventh Circuit opinion will somehow open the floodgates for foreign corporations to contest the taxing practices of other states in state or Federal courts is groundless.

**IV. The direct, inherent, and adverse impacts of Petitioners' use of worldwide combined reporting which provide standing for foreign corporations to contest it in Federal courts, also prevent the United States Federal Government from speaking with one voice in matters of international trade.**

The direct burdens on foreign corporations, the interference with their foreign commerce, and the offense to the United States' trading partners imposed by Peti-

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[25] Brief for the Petitioners, p. 42.

[26] *Alcan Aluminium Ltd. and Imperial Chemical Industries PLC v. Franchise Tax Board,* 860 F.2d at 698 (7th Cir. 1988).

[27] Brief of *Amici Curiae* in Support of the Petitioners by the State of Idaho and Several Other States, p. 1.

tioners' use of WWCR not only creates standing for foreign parent corporations, but also meets this Court's tests to determine the unconstitutionality of state taxes: its use is at variance with federal policy and has implicated foreign policy issues which must be left to the Federal government.[28]

These tests confirm that California may not act as a sovereign nation in the international realm and tax the income of multinational enterprises under an aberrant and contradictory system which interferes with the Federal Government's ability to speak with one voice and which, as seen above, results in double taxation. This case, as opposed to *Container*, involves a foreign parent corporation with a domestic subsidiary. Here there is: (1) an "automatic asymmetry" between Petitioners' use of WWCR and the acknowledged international tax structure; (2) the tax is imposed on a foreign corporation and its domestic subsidiary; and (3) it is a matter of international concern because the United Kingdom and other nations are interested in insuring equitable taxation of their corporations.

That Petitioners' use of WWCR prevents the United States from speaking in one voice has also been clearly established. The Executive Branch of the Federal Government has filed an *amicus curiae* brief in this case in support of Respondents which: (1) makes clear that the Federal Government views WWCR as a threat to the United States' foreign policy; and (2) contains statements by the President, the Secretary of the Treasury and the Secretary of State that the taxation policy of the United States for multinational corporations is AL/SA.[29]

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[28] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[29] Brief *Amicus Curiae* of the United States, Civil Action No. 84-C-8906 United States District Court for the Northern District of Illinois, Eastern Division.



## CONCLUSION

This case brings to this Court a matter which it has previously specifically not addressed—the significance of a foreign parent corporation and its domestic subsidiary in assessing the unconstitutionality of Petitioners' use of WWCR. The United Kingdom is anxious to have that issue resolved before more harm is done to United Kingdom corporations and to United Kingdom—United States relations. The United Kingdom believes this Court would not have left the issue unresolved in *Container* if it had any doubt that foreign parent corporations have standing to bring the issue before it. The disruptions that have been caused by Petitioners' insistence upon the use of WWCR will only increase if foreign parent corporations, like Respondents, are deprived of their standing which the Seventh Circuit Court of Appeals upheld.

For these reasons, the decision of the Seventh Circuit Court of Appeals should be affirmed.

Respectfully submitted,

F. EUGENE WIRWAHN
511 Woodland Court, N.W.
Vienna, Virginia 22180
(703) 938-5634
*Counsel for the Government of the United Kingdom as Amicus Curiae*